BLACKSTONE Third Quarter 2016 Earnings Investor Call
October 27th, 2016 11:00 a.m. ET

Weston Tucker: Good morning and welcome to Blackstone's third quarter 2016 conference call. I am joined today by Steve Schwarzman, Chairman and CEO; Tony James, President and Chief Operating Officer; Michael Chae, our CFO; and Joan Solotar, Head of Multi-Asset Investing as well as External Relations. Earlier this morning, we issued a press release and slide presentation of our results, which are available on our website. And we expect to file our 10-Q report in a few weeks.

I'd like to remind you that today's call may include forward-looking statements, which are uncertain and outside of the firm's control, and may differ from actual results materially. We do not undertake any duty to update these statements. For a discussion of some of the risks that could affect the firm's results, please see the Risk Factors section of our 10-K.

We will also refer to non-GAAP measures on this call, and you'll find reconciliations in the press release on the shareholders' page of our website. Also note that nothing on this call constitutes an offer to sell or a solicitation of an offer to purchase any interest in any Blackstone fund. This audio cast is copyrighted material of Blackstone and may not be duplicated without consent.

So a quick recap of our results: we reported GAAP net income of $692 million for the quarter and $1.5 billion year-to-date; and year-to-date period was up 20 percent from the prior year. Economic net income, or ENI, grew sharply to $687 million in the third quarter or $0.57 per common unit. Distributable earnings were $593 million in the quarter or $0.48 per common unit and that equates to a distribution of $0.41, and that will be paid to holders of record as of November 7th. With that, I will now turn the call over to Steve.

Steve Schwarzman: Thanks, Weston, and thank you all for joining our call. Blackstone delivered a compelling set of results in the third quarter with strong economic net income and substantial distributable earnings as Weston mentioned and another quarter of great fundraising success, particularly when compared to outflows for many traditional money managers.

In the past 12 months alone, our limited partners – we call them LPs – have entrusted us with nearly $70 billion in new capital which despite $38 billion in realizations brings us to another record for assets under management of $361 billion. We continue to see strong positive growth in every one of our businesses. Blackstone continues to be the solutions provider our limited investors need, perhaps now more than ever in a world of sluggish growth, record low interest rates, high public market valuations, and the resulting very low returns for most asset classes. These challenges seem likely to persist for some time which is causing real problems for LPs.

Just to cite a few examples for you, the average endowment in the United States for the 12 months ending June 30th lost between 1 and 3 percent on their portfolio. The best performing major endowment in the United States that I am aware of earned only about 3 percent. But most lost money. The average public pension fund, which I think is sort of shocking results, basically earned approximately zero for the last year. In this context, what are they to do? How can a pension fund, which has got an actuarial target of 7 to 8 percent per year but is invested in a mix of mostly public stocks, fixed income and treasuries but which are returning very little ensure that it can honor its future obligations?

Blackstone has successfully delivered investment solutions to these LPs over a period of decades and across all market cycles. We've done this by innovating new products in response to changing market dynamics, leveraging our market leading global platforms where information flows around the firm to better source investments, utilizing our asset management expertise to improve the operations of our investments and drive value creation, and keeping a long-term perspective with a business model that can ride out and take advantage of periods of volatility due to the locked in nature of our funds.

The result of all of this has been really strong performance. Over the past 5, 10 and 15-year periods, investment in our flagship drawdown funds would have generated a 15 percent net IRR to our investors. That's after all fees. On a realized-only basis, which is how some people report, which largely excludes the impact of tens of billions of dollars of recent investments, there is still seasoning. That IRR becomes approximately 20 percent net of all fees here at Blackstone. While we obviously can't guarantee future returns, our historic record is quite compelling certainly given the mediocre results that almost all organizations are reporting.

In the third quarter specifically, our corporate private equity and real estate funds were up 3 to 4 percent, bringing them to 7 to 9 percent year-to-date, broadly outperforming global markets with less volatility. In credit, our various strategies were up 6 percent gross for the quarter and 11 to 17 percent year-to-date. In our hedge fund area, BAAM's composite was up around 3 percent gross in the quarter with continued low volatility of only about one-third that of the S&P.

Our consistent performance at high levels is why our investors keep coming back to us with greater and greater commitments, across more of our funds. We've raised $14.7 billion just in the third quarter. Here is a pretty stunning fact. In the past 10 quarters, we have raised nearly $200 billion, more than the aggregate size of any of our domestic alternative peers. And given the secular forces driving capital into the alternatives we continue to nicely grow.

Combined with Blackstone's powerful and unique competitive position, I remain quite optimistic in our ability to keep growing with one of the largest, if not the largest, platforms in each vertical area, private equity, real estate, hedge funds and credit. We are able to accept and responsibly deploy billions of dollars from individual LPs which is a critical capability that few, if any, other firms can offer.

Against this challenging investment backdrop which is persistent for several years now, our return targets on new investments remain at least equal to the returns we've delivered in the past.

In fact, we have already achieved net returns well into the double digits for our most recent vintage funds including 20 percent net IRRs for our two most recent Global Real Estate Funds; 17 percent for our 2013 Asia Real Estate Fund; 14 percent for our 2011 Energy Fund; and 11 percent for BCP VI. We stick to a religious and rigorous discipline around investing, and we stay away from challenged areas like paying full multiples for public companies unless we have a very specific path towards achieving value creation.

That discipline can constrain certain businesses at certain points in the cycle; but we have no shot clock in basketball, so to speak; and we don't have to be fully invested until we see things we like. You are not just buying a market if you invest with Blackstone like you do with public securities. Our locked-up funds structures allow us to do nothing at all; while at the same time, our flexible global mandates let us shift to where the opportunities are most attractive. And our entrepreneurial mindset, lets us create new products to take advantage of new opportunity sets which translates into greater capital deployment. For example, our three largest new initiatives – Real Estate Core-Plus, Tactical Opportunities and our Strategic Partners secondary business – together invested $10 billion in the past 12 months or 30 percent of Blackstone's total investments.

Because we are a long-term business, which is increasingly diverse across products, regions, and fund structures, even today in the current environment, we are able to deploy significant dollars into new investments. In Private Equity, we've been very carefully navigating the high-priced environment, largely avoiding auctions where the pricing gets bid up. We focused on unleveraged, free cash flow yields where our basis is de-risked over time. We looked into buying companies with scope for operational improvements, structured with very limited downside.

We've been active recently in energy, as Tony mentioned in the press call, announcing we are closing 10 deals for $2.7 billion in equity investment so far this year. We have the benefit of being able to take a long view here as well looking for assets with lots of reserves in the ground and a low breakeven but are in the development stage and may be cash flow constrained. We typically partner with private companies which don't have the same access to capital as public companies; and we are looking to build businesses, bring the individual acreage parcels, for example, together that can be taken public or that can be attractive to a strategic buyer.

Real Estate remains an attractive asset class globally although there is less distress today. We expect fundamentals to remain solid for the foreseeable future. In most markets, supply remains constrained. Demand for high-quality real estate is strong. Debt levels are not excessive and bank competition is diminished. We've been expecting interest rates to increase for some time and have baked that into our underwriting assumptions for new deals. Historically, when rates have increased, it's generally been reflective of greater economic activity which in that scenario is good for our business. Against this backdrop, we continue to invest large scale capital at discounts to physical replacement cost.

We have meaningful advantages including our global reach, scale and knowledge, our ability to move quickly and decisively, and our best-in-class asset management capabilities. In addition to remaining active in our opportunistic and debt areas, we are seeing great deal flow in our core-plus area, which is a bigger and deeper asset class than the opportunistic area. In credit, we've taken advantage of the market drops this year, particularly in energy and Europe, where we've concentrated our deployment. We've focused on debt higher up in the capital structure with sufficient downside protection and attractive yields.

Overall, we are finding interesting ways to deploy capital across all of our platforms and only need to do a few deals in each of our areas focusing on those opportunities where we can create value. While we remain quite active on the investment side, at the same time, we have taken advantage of market conditions to sell assets and return capital to our LPs.

We have had $13.6 billion of realizations just in the third quarter, bringing us to over $29 billion year-to-date. And our pipeline for sales is strong. There is enormous liquidity around the globe now looking for a home. And so in addition to the many realizations we have already signed up, which will close over the next several months, I am optimistic we'll see many more and that would be positive for our distributable earnings.

Michael will discuss our distributable earnings outlook in more detail, but one realization I would like to highlight is our agreement to sell the majority of our remaining stake in Hilton. The sale price reflects three times our original basis; and combined with past sales and remaining unrealized value, we've generated a total profit of more than $12 billion, which I think is either the largest or second largest private equity profit in history, not just for Blackstone but for the industry.

To remind everybody, this was a pre-crisis investment, a so-called peak of the market 2007 leveraged buyout. Our thesis was to take a great group of brands and turn them into a tremendous global business with an outstanding management team focused on accelerating growth. Since our acquisition in 2007, we successfully grew Hilton's global system by 60 percent and doubled the cash flow of the company.

Because of our locked-up capital, even in the depths of the financial crisis, we were able to stick to our plan without the pressures of quarterly earnings targets or investors redeeming at the worst possible time. This is how investing works at Blackstone, and this is how we can help our LPs solve the issues they are facing today. With time on our side, we can create significant outperformance operationally versus what can be done in the public markets.

Despite these capabilities, as Tony mentioned, our stock today is still yielding nearly 8 percent based on the last 12 months distributable earnings or 6.5 percent based on our distributions. How many large-cap investment grade rated companies have this high a yield? The answer, as you know, is very, very few. If you listed the top 500 largest companies in the world, Blackstone would be in the top 10 in terms of yield. But who needs yield when you can invest at 1 percent with government bonds?

Meanwhile, the S&P is yielding just around 2 percent today. On this basis alone, Blackstone stock seems like a pretty good investment to me; and I obviously own a lot of it; and I am happy Blackstone shareholder. Our limited partners, including many of the most sophisticated investors in the world, have selected Blackstone as their partner of choice with the vast majority of them re-upping into successor funds over time.

I look forward to the day when the public markets catch up with our limited partners with respect to Blackstone's stock and afford us a premium value the same way our LPs put a premium value on our funds. In the meantime, we continue to focus on what we do best, creating great investment solutions which should ultimately translate to growing distributions for our unit holders. Thanks for joining the call and now I will turn things over to our Chief Financial Officer, Michael Chae.

Michael Chae: Thanks, Steve, and good morning everyone. Blackstone's third quarter results illustrated continued strong momentum in every one of our business lines with each one reporting both year-over-year and sequential growth in revenue and economic income. Investment performance remains strong across the board and we continue to attract significant new capital driving sustained growth in AUM, again, in every business. ENI rose sharply to $687 million, our best performance in the past six quarters, driven by accelerating performance fees and investment income across the businesses. Indeed, in the third quarter, each of our businesses posted their highest level of performance fee revenue in at least five quarters.

Total AUM rose 8 percent year-over-year to a record $361 billion, driven by nearly $70 billion of inflows over the past 12 months. The diversity and scale of those inflows was impressive between $10 and $21 billion in each of our business segments. Total fee earning AUM again rose by double digits, up 11 percent to a record $268 billion. Fee-related earnings rose sequentially to $229 million in the quarter despite the first full quarter impact of the BCP VI step-down triggered in May and in advance of BCP VII commencing full fees in early November. Year-to-date FRE was $675 million, up 8 percent despite the spin of our advisory businesses on October 1 of last year. Adjusting for the spin, year-to-date fee-related earnings were up 21 percent year-over-year reflecting approximately 230 basis points of underlying FRE margin expansion.

Now, I'd like to review briefly the highlights of the results for each of our businesses, starting with Real Estate. Performance remained strong across all real estate strategies in the quarter, with the opportunistic funds up 3.7 percent and core-plus up 2.9 percent with continued healthy operating fundamentals evident in substantially all of our global portfolio, as Steve discussed. We continue to be able to find new investment opportunities at scale even in this environment, with $1.7 billion deployed and another $3.4 billion committed to new deals.

There is significant demand globally for income-producing assets, which is sustaining a robust realization pace for our real estate business. Third quarter realizations in real estate reached $7.3 billion, the second highest quarter ever for that segment, generating $466 million in realized performance fees, which was our third highest quarter ever. This brings real estate realizations to $14 billion year-to-date and keeps us on track to approach $20 billion again in 2016, which would be the third year in a row at that level. That is an extraordinary data point.

And we are not planning on slowing down with clear visibility on a number of large monetizations over the next 12 months to 18 months. I think it's noteworthy that despite $56 billion of realizations in real estate over the past 11 quarters, segment AUM is up nearly 30 percent over that same period. It's a testament to the dominant platform we've built in this space and our ability to leverage it to build scale new businesses when we see complementary opportunities, such as in the debt and core-plus areas, all resulting in a replenishing and indeed growing store of value for future harvesting over the long-term.

In credit, GSO had another great quarter with gross returns for the various strategies of over 6 percent for the quarter and on a year-to-date basis, 17 percent for our performing credit strategies cluster and 11 percent for our distressed strategies cluster. Performance was driven by continued appreciation of energy investments as well as in distressed debt positions across funds. Global demand for our credit product remains very healthy.

GSO reported $5.7 billion of inflows in the quarter, the highest of any of our businesses and $15 billion year-to-date. In the five months since its first closing, GSO has raised $6.5 billion for its next flagship mezzanine fund with expectations to hit its cap imminently. We added over $600 million in separate accounts with large LPs in the quarter, and we raised over $500 million for a new European CLO bringing us to $2.3 billion of global CLO issuance through September and $3.4 billion, including two more new issuances this month, making us the largest global CLO issuer for the fourth year in a row.

While the deployment environment is currently challenging, GSO has remained quite active investing $2 billion year-to-date with another $1.3 billion committed to deals that should close in the next few months and a strong backlog of deal flow that could result in a robust fourth quarter of new commitments. We earn management fees on GSO’s drawdown capital as it is invested, so we will benefit as these pending deals close.

In the face of benign general credit market conditions, we are still able to find good opportunities by leveraging our global origination platform and brand, by using our size to be a unique scale solutions provider to companies, and by going where the need and value maybe at a given time, for example, in the energy space and in the European direct lending areas. Against the backdrop of the significant structural changes and retrenchment in the global banking system, we expect that we can deploy GSO’s dry powder balance of $20 billion attractively in the coming years, driving meaningful upside to our segment earnings over time.

In hedge fund solutions, BAAM’s composite gross return was up nearly 3 percent in the quarter, putting 67 percent of their eligible AUM above the high water mark and resulting in the resumption of positive performance fees. That 67 percent figure compares to 10 percent as of the end of the second quarter, so significant progress was obviously made.

Demand across the BAAM platform remains quite strong with no abatement in our inflows which were $3.3 billion in the quarter, including October 1st subscriptions, and $8.5 billion year-to-date. Our fee-earning inflows for the first nine months of 2016 were stable with the same period in 2015. We’ve won a number of large mandates in our core business, plus are seeing continued consistent gross inflows of over $1 billion per quarter in our individual investor solutions area which has now reached $7.2 billion in AUM, up 28 percent year-over-year.

Overall, year-to-date net inflows, including October 1, were a positive $1.7 billion. That compares favorably to moderate net outflows overall for the industry. Our enduring competitive position in the hedge fund area stems from our leading scale and distinctive value proposition for clients where nearly 70 percent of our assets are in strategies customized for BAAM and/or have a fee discount with the underlying managers.

Turning to Private Equity, our corporate private equity funds appreciated 3 percent in the quarter with strong 5 percent appreciation or private portfolio, partly offset by a flat quarter for our publics. Like Real Estate, our Private Equity business had a strong quarter for realizations, reaching $4.5 billion, primarily through sales of public positions.

I'd like to spend a moment on our energy activities in private equity, as it is quite instructive about our model of buying and selling assets and how we operate. After not investing in any new upstream energy assets in 2015, this quarter, as Steve alluded to, we closed on three upstream deals representing $1.3 billion in aggregate equity capital. Together with a fourth deal closed in the second quarter, we deployed or committed just under $2 billion of capital into four high quality upstream oil deals where we set the price earlier in the year near the bottom of the market.

And indeed, since then there have been multiple handfuls of deals by others in substantially similar acreages, valuing like assets at approximately two to three times what we paid on a per-acre basis. At the same time, over the past year, we have aggressively pursued sales of many of our contracted power assets in an environment where investors globally have been valuing very highly assets with cash flow certainty and current yield. And so this year, we have agreed to sell five different power assets located across four different continents – North America, Europe, Asia and Africa – for aggregate equity proceeds of $2.4 billion and $1.4 billion of gain. One closed this quarter and the other four sales we expect to close in the next couple of quarters.

The broader point here is that private equity environments are not monochromatic. We look for areas of dislocation and patiently position ourselves to strike when the time is right. And even within a single industry, in this case energy, we can be active buyers of one sub-sector and active sellers in another contemporaneously.

As I discussed last quarter, and which you can see in our results today, BCP V sales are not currently converting to distributable earnings. This is due to the sequencing of certain sizable realizations this year at lower multiples of invested capital that, given the long hold periods, did not exceed the accumulated preferred return. The fund remained substantially in carry on a total fund basis and we are accruing carry with additional gains.

To be quite specific, prior to this year, the cumulative multiple of invested capital, or MOIC, on BCP V realizations was two times. The MOIC on realizations this year has been 1.15 times, but the carrying MOIC on the remaining portfolio is 1.7 times, and three quarters of this is in liquid public positions. And so if we sold everything today, we'd crystallize and pay out BCP V's entire net accrued performance fee receivable of $306 million. As we said last quarter, this is a timing issue which we expect to be resolved in the next couple of quarters.

Moving to the outlook for distributable earnings: the outlook, particularly as we begin to look forward to 2017, is quite positive. First, as I mentioned before, we expect FRE to grow at a strong double-digit percentage next year with one key driver of that growth starting in a couple weeks as the fee holiday on BCP VII ends. In total, we have over $65 billion of management fee eligible AUM that will start earning fees once certain investment periods begin or when capital is invested, which should drive meaningful FRE growth over time.

Second, we expect to remain very active from a realization perspective. Besides closing $13.5 billion of sales in the third quarter, we have approximately $8 billion of pending realizations under contract or letter of intent, which will close in the fourth quarter or early 2017. Those realizations are successful deals with good returns, averaging around 2.7 times the original basis. About half of the $8 billion is in real estate comprised of Hilton and a diverse set of other assets in the US, Europe, and Australia. The other half is in private equity comprised of energy assets in Asia and Mexico, the previously announced transaction involving Change Healthcare, and Hilton.

We also have multiple other investments we expect to exit or start the exit process in 2017. We ended the quarter with $17 billion in publics across the firm which we're actively selling down and which traded at values of 2.6 times multiple invested capital in aggregate as of the end of the third quarter. In this context, let me take a minute to provide a little more detail on the Hilton sale because of its magnitude and the impact to DE. We expect the sale to close in the early part of 2017 and generate gross proceeds of $6.5 billion or $4.6 billion after the pro rata pay-down of existing margin debt.

In addition to the net performance fees generated, we will benefit from the firm's direct investment, resulting in a total DE per unit impact of approximately $0.27 per unit in early 2017. The sale will also drive BCP V towards resuming cash carry possibly in the first quarter of 2017 by closing out over three quarters of the current preferred return shortfall.

Finally, the combination of the Hilton stake sale and the Change Healthcare and power asset sale transactions, also scheduled to close early next year, together are expected to drive over $500 million or over $0.40 per unit in distributable earnings in the early part of 2017. So taken together, our 2017 FRE trajectory and our anticipated 2017 realization pipeline and performance fee momentum, we feel very optimistic about the outlook for strong 2017 from a DE standpoint.

A final note in our balance sheet, late last month we opportunistically tapped the Eurobond market with a €600 million issuance of 10-year notes at a 1 percent coupon, priced within a couple basis points of the benchmark rates all-time low. This was our second offering in Europe and the capital will serve to help hedge our significant operations there, as well as provide us with additional strategic firepower.

Investor response was tremendously positive, reflecting not only today's strong demand for yield, but also the strength and health of our franchise and the power of our business model. Our A+ rating was reaffirmed by both agencies, a testament to our rock solid balance sheet and prospects. We ended the quarter with a $3.9 billion cash and treasury position or $1.1 billion in excess of $2.8 billion of total debt with a weighted average maturity of about 14 years.

In closing, Blackstone continues to benefit from the expansive diversity of our business lines and the durability of our model. We continue to raise a lot as expected. We're selling a lot. And although the environment has been more challenging for deployments, we are deploying a substantial amount as well building the basis for future realizations.

In a world where pensions and endowments have been struggling to earn adequate returns, we believe Blackstone is one of the few firms that can solve their issues in scale and that we will continue to be recognized as the partner of choice. With that, we thank you for joining the call and would like to open it up now for questions.

Weston Tucker: We have a fairly sizable queue here. So if everyone could please, on the first round, limit your question to one question, one follow-up, and then come back into the queue if you have additional follow-ups, that would be great.

Operator: Ladies and gentlemen, if you wish to ask a question, please press star one on your phone. Again, for audio questions at this time, please press star one to begin. And our first question comes from the line of Glenn Schorr with Evercore ISI. Please proceed.

Glenn Schorr: Thanks very much. I'm curious. I heard your comments on the real estate backdrop pipeline, Core Real Estate+. Got it all. I am curious on Blackstone's decision to go the non-traded REIT space in terms of the Blackstone Real Estate Income Trust.

Mostly just a question on fee structure of the wrapper that you are going in. I know that goes to the distributor but it seems a little different than everything else you've done in the past.

Steve Schwarzman: I think we are basically prohibited at this point in the SEC cycle to be talking about that product. So I would like to respond to you, but we can't, so we won't.

Glenn Schorr: Ok.

Weston Tucker: Sorry, Glenn. We will give you another question for that.

Glenn Schorr: No problem, no problem. The flipside, there's been tons of questions on the traditional asset managers on how they are adapting to DOL world, and it's usually related to some version of you get less assets and you charge less fees and that's in the traditional side. For you guys, do you think about it as we've talked in the past pensions have a large allocation – pensions, endowments, others have large asset allocations to alts. Wealth management clients don't. Can the DOL world, especially with asset allocation models in place, can that actually accelerate the pickup of your products in the wealth channel and are you actively pursuing that? Obviously, the institutional world is a bigger driver of your flows but just curious how you think about it?

Joan Solotar: Yeah, I think it is a great question. And the approach is really to take institutional quality product and make it accessible to where it wasn't previously. And so a lot of this is pulled from the different institutions who, one, want to increase the individual allocations which are creeping up but still low single digit and they want it from high-quality asset managers. And when you think about our portfolio going from the most liquid to illiquid in alternatives across the asset classes, we're able to work with them and just design bespoke product for those channels. So we think it's a huge opportunity actually in very early stage.

Michael Chae: Yeah, a lot of our products are being designed and structured to where they will fully qualify for any Department of Labor standards that we could want or anyone could want, number one. And number two, we're finding that if you take the commission-based salesman out of that, there's actually more appetite in some ways for our products because, you know, commission-based salesman can sometimes like liquidity because they can buy and sell things and there is activity for its own sake. And so we are finding that some of the investment advisers that are not commission-based have been very good retail clients for us.

Glenn Schorr: Joan, do you have to do anything different or just more of it in terms of penetrating that channel and are you? In other words, are you accelerating your efforts there given that opportunity?

Joan Solotar: So we are accelerating the efforts, and you do have to do more than just show up. It's a real education process for the advisers and for their clients who again traditionally have not been in this asset class. So it's very much person by person, and I think our scale in that sense hugely benefits us. I mean what we've put in place just over the last six years, I believe is really unmatched in the alternative industry and we are continuing to move forward.

Tony James: And I've talked about this before, Glenn. This is not simply just throwing your product out there in these systems and letting it sell itself. If you're going to do this right, you take on a real obligation to these investors to provide them world-class service.

So you have to build a real service organization that deals with different kinds of investors in different ways and different products. You also have to educate the intermediaries, the investment advisers, the brokers, and so on. They're not going to sell products they are not comfortable with at the fundamental level. So there is a big educational component of this. Then you have to design products that fit with the different regulatory needs and market appetites all around the world, not just the United States. So there's a major product structuring aspect of this.

And so if you are going to really do this right, you're building a whole organization and infrastructure. It's not at all casual and have a booth and let someone come and try to sell them a few shares of or a few bits of private equity. And I think this is one area where our scale and the diversity of our products is a huge advantage because we can afford to make that investment so that we are a really, really high-quality counterpart for any kind of distribution organization out there to retail investors; and essentially no other alternative firm has the scale and breadth of products and quality of products to be able to do that.

Steve Schwarzman: And the brand name.

Michael Chae: And as Steve points out, and the brand name.

Glenn Schorr: Great. Thank you.

Weston Tucker: Thanks, Glenn.

Operator: And our next question comes from the line of Patrick Davitt with Autonomous. Please proceed.

Patrick Davitt: Hey, good morning, thanks. So there's been a lot of press and announcements about hedge fund redemption and fee cuts, and I wanted to ask around that from two perspectives. One, do you feel like there is an opportunity there for BAAM to have even more pricing power? And two, have you started to rethink your direct investments in hedge funds as a result of those trends?

Tony James: I guess I'll take that one. There's a lot of activity in hedge funds, but it's not so much like the whole industry is under duress, despite what you might read, is there are some big winners. There're some sectors losing but there's some big winners too. And what you're really seeing is you're seeing assets flowing from the sectors that have struggled to distinguish themselves on returns to the sectors that are actually doing quite well. And I think your pricing power is kind of a function of where you are in that equation.

The other thing is, there's certain segments – one of the things that's happened with regulation is they've impacted liquidity – and Steve's talked about this over the years. They've impacted liquidity of credit markets. And so certain kinds of asset classes like, for example, credit funds, don't have liquidity that they used to have. That has implications for fund structures, and so you'll see some people may be taking slightly lower fees but having more locked-up capital. And we think the net-net for our business is that's a good trade.

But as far as BAAM goes, I don't know that BAAM's getting more pricing power necessarily, but I think the fact that the area is – there's a lot of change going on that's good for BAAM. And it's one of the reasons that they're seeing a lot of net inflows in an industry where there's probably net outflows because, again, people want someone who really knows what they're doing, where are the winners, where the losers are. And so I think it's net good for BAAM. I'm not sure it's reflected in pricing power so much as AUM.

Steve Schwarzman: But remember**,** BAAM is the largest investor in hedge funds and has very substantial ability to have an impact on fees paid. And that's one of the reasons why people like to invest with us because you get a very good economic thing and the hedge fund industry is really -- total redemption is about 3 percent this year and BAAM is up. So that is not too bad.

Tony James: Right. So I probably answered the wrong question. If you are talking about BAAM's ability to extract price concessions from managers, then, yeah, obviously that has gone up. I was more talking about BAAM's ability to charge its investors but yeah.

Patrick Davitt: That's what I was referring to, thanks. And then the direct investments in third-party hedge funds? Are you still kind of comfortable with that strategy despite the headwinds?

Tony James: In the managers – in the GPs – in the managers themselves?

Patrick Davitt: Yes.

Tony James: Yes, we have a pool of capital. We're very optimistic that will earn very high returns for its investors. But it's a managed pool of capital. We're not doing it on our balance sheet like some other places.

Patrick Davitt: Okay, thanks.

Operator: And our next question comes from the line of Craig Siegenthaler with Credit Suisse. Please proceed.

Craig Siegenthaler: Thanks. Good morning, everyone. It looks like five larger funds may have just hit their final closes or are pretty close. In core-plus and BREP Europe V are two of the larger funds still open in 4Q, excluding the funds that are always open, should we expect a deceleration in aggregate fundraising activity as we walk into 2017? And maybe just any other commentary on the fund-raising front would be helpful.

Michael Chae: Sure, Craig. Look, we are obviously coming off of an extraordinary 2015 where we raised about $94 billion, LTM we've raised $69 billion. This year, I think we said this on some prior calls, year-to-date has been $53 billion and we're working on a really solid year. In terms of the outlook, there's still some significant, in addition to kind of the always-on fundraises, as you mentioned, significant drawdown funds coming up. We've got next year possibly a third – a second Asia fund, a third capital solutions vehicle, possibly a third comingled Tac Ops vehicle.

So certainly the large flagship global private equity and real estate funds were obviously raised in the last couple of years, but there's still chunky drawdown product to come as well as all manner of other products and products under development. And so I think you will see us next year and into 2018 maintaining relative to this year's kind of run rate level, a very healthy level of fund-raising.

Craig Siegenthaler: Great. Thanks for the color, Michael.

Operator: And our next question comes from the line of Alex Blostein with Goldman Sachs. Please proceed.

Alex Blostein: Hey, guys. Good morning. I want to go back to your point around the opportunistic raise of $1 billion in Europe, obviously at a very attractive rate. The balance sheet continues to have lots of liquidity. So I was wondering if you could spend a couple of minutes on the use of that firepower, as you called it. And also secondary to that, anything we can anticipate from you guys on the share repurchase front. I know that tends to come up every quarter but given the valuation level and Steve's comments, wondering if there was any evolving thought process there. Thanks.

Michael Chae: Sure, Alex. It's Michael and I'm sure Steve and Tony may want to chime in. And obviously, we have grown to expect this question and we are happy to engage on it. We like the balance sheet strategy we've committed to. First of all as a general matter, to kind of use – paraphrase a term of art -- we have a fortress balance sheet that in all environments, all business conditions, all market conditions will more than ensure that our firm will thrive, not only thrive but capitalize on moments of dislocation in the greater world.

In terms of kind of going on offense and our capital strategy and uses of capital, obviously we think in general we have very attractive internal uses of capital. First, in terms of organic growth, seeding, and investing in our own products, the return on assets has been in the 5 to 20 times level in terms of what a new product will deliver for a balance sheet investment for the firm over a 10-year basis and we continue to see a great universe of opportunities there.

And then as you know, on an inorganic M&A basis, strategic basis, we have been very selective in making investments over our post-IPO history. We've done eight of them and they've been – we've been very selective and they've been very successful. They've generated returns as sort of portfolio investments in the 30 percent annualized rate of return area and we continue to see, in all modesty, we think we're sort of the partner of choice for most people who want to do a deal. And so we see lots of things and we are looking at lots of things.

And also moreover, we think we've carefully managed our share count dilution to help mitigate or negate the need for repurchase. Since our IPO, we have averaged about 0.7 percent dilution per year in our unit growth and I think in the last five quarters or six quarters, it's been about 0.4 percent. And if you actually compare that to many of our peers with so-called share repurchase programs on, I think it's pretty competitive. So that's sort of the framework and we never say never. At some share price a repurchase could become more attractive than other capital uses, but we apply a very rigorous lens to analyzing that and that lens is not short-term value creation but long-term sustainable value creation for our shareholders.

Alex Blostein: Okay, thanks.

Operator: And our next question comes from the line of Brian Bedell with Deutsche Bank. Please proceed.

Brian Bedell: Hi. Thanks very much. The first question about the retail channel, obviously you have an extremely compelling case for a lot of your products in the retail channel [inaudible] DOL. Can you talk about how we can track the progress on this because obviously like you said – I think you said – the market share is creeping up, but in terms of actually the distribution effort and talking with gatekeepers and getting the product in the channel, having the advisers be educated, maybe if you could just shed some light on what you would characterize as AUM in the retail channel now and then how we would go about tracking that?

Joan Solotar: Yeah, so currently today, it's approximately – well, just through the wire houses alone, we've probably raised about $18 billion; and that number continues to grow. It's going to be, without going into specific product as Tony said, a real mix of illiquid and liquid product. And as we grow into new channels within retail, we'll be able to go from the ultra-high net worth down to dollar one investors with appropriate product. I think we can start providing you with more regular information on it in terms of – we do often in our presentations breakout at a firm level how much is retail versus institutional and so we can continue to do that.

Michael Chae: And just to add to Joan's point, Brian, inception to date our cumulative percentage of total capital raised and retail has been about 10 percent. But in recent years, as we've amped up the effort, it has run at between sort of 15 to 20 percent of the total for the last three years. So that gives you a sense of the trajectory.

Steve Schwarzman: And that's in an environment where our drawdown funds are all oversubscribed. So we're turning away retail demand. And inevitably, because historic institutional clients -- we're not going to push them out of the nest when they have been with us for several years. So it could've been much bigger than that.

Brian Bedell: Right, and that's another good follow-on question, I suppose, in terms of, is there a product creation capacity to satisfy that retail demand or do you think you will be in that dynamic whereby the supply is a little limited relative to the demand?

Joan Solotar: Yeah. I mean I think each of the channels has different appetites; and so if you think about the independent broker dealer channel, they're much more focused on liquid product where we are not currently capacity constrained. And so I think over the next several years, you'll continue to see us accelerate that and you will see that build out. And with that, again, we can't talk about specific product, but one of the nice elements of it is that you grow by both inflows and asset appreciation, so it's quite steady and you are not in the drawdown structure of giving back capital and having to reacquire it, if you will.

Brian Bedell: Right. Okay, great. Thanks very much.

Operator: And our next question comes from the line of Michael Cyprys with Morgan Stanley. Please proceed.

Michael Cyprys: Hey, good morning. Thanks for taking the question. There's been some concerns on commercial real estate, perhaps too much supply maybe in certain markets, maybe some pressure on rents. Just curious if you could talk about what you are seeing in terms of pressures in certain parts of the market and how Blackstone is positioned around that? And just secondly on that, if rates do rise, how do you see that impacting your portfolio? I know you mentioned that historically when rates rise, economic growth is typically growing. But what about if that's not necessarily the case and economic growth is consistent with what we are seeing today? What happens in a rising rate environment?

Tony James: Okay, Mike. So in -- the market now is very healthy. It's a healthy moment for real estate. We don't think there is a bubble, and we don't see the amount of new building that presages a downturn. But at the same time, economic growth may not be spectacular but it's steady; and population growth chugs along at 0.8 percent; and obsolescence in commercial real estate chugs along at 0.4 percent. And the combination of economic growth, obsolescence, population growth, and not a lot of new building means that occupancies continue to rise; and when occupancies rise, rents rise. When you get those two things with basically a fixed cost asset, you get very healthy operating income. So that's the general picture in the United States. We could go around the world if you want, but I assume your question is primarily US-based.

Now, there are certain segments and certain markets where the picture's a little different based on the regional thing. In Houston, given what's happened to energy, obviously, the office market is a little softer. In high end residential pretty much all over the world, condos and things like that, the market is soft.

Steve Schwarzman: We don't do those.

Tony James: Fortunately, we don't do those. And you have, I think, New York City we've got near record building; but at the same time, the city is doing very well and the market is in a stable position. As rates rise, obviously, cap rates will sneak up; but the drop in rates was not fully passed through on cap rates. In other words, the spread over base rates came up. So as rates rise, some of that will be absorbed we think by a return to more normal spreads. And we are not really in the business of betting on cap rates staying where they are. Usually we buy something and we expect on exit cap rates to be higher anyway, and that's what we underwrite to. So that's our premise and we think that as long as the environment stays healthy – it doesn't have to be hot by any means. It just has to stay healthy the way it is today. Then rising rates are what we are expecting and we're going to get our returns.

And again, we make our money by – particularly in the BREP fund – by buying un-stabilized assets where there is value improvement, improving those assets, converting it into core real estate which has a fundamentally different lower cap rate than what we pay and being able to create value that way.

Mike Cyprys: Great. Thanks, Tony. And if I could just ask a follow-up for Michael, you quantified the Hilton monetization I think around $0.27 that you threw in the first quarter of 2017. Just given that you have locked in the sales price here, how should we think about the impact to ENI in the fourth quarter? Do you mark up that position to the sale price? Is there any sort of discount? And then how should we think about the moving pieces around the portion that is the BCP V fund, given that's kind of sitting right at the 8 percent pref? Should we think about a catch-up that around 80 percent or so or something less?

Michael Chae: Good question, Mike. And on the first part, I guess, we'll see. You are saving us having to do a lot of individual questions to help you guys – calls to help you guys with your models. In terms of a markup prior to the deal, we'll observe our normal policy where, say, at the end of the fourth quarter, we'll look at deal certainty and so forth and timing and make a decision. I will say in terms of kind of the quantum of ENI pickup for that stake which we are selling at that price, all else equal, it would be in the $100 million area in terms of pickup to ENI.

As for your question on BCP VI, Mike, was your question in terms of how the Hilton sale will affect the movement? I think I mentioned quickly in my remarks that one of the great benefits of this Hilton stake sale will be – it will substantially close out that preferred return shortfall for

BCP V that I mentioned, about three quarters of it, and put us in a position to generate cash carry again in that fund in sort of as early as the first quarter.

Mike Cyprys: Got it. Okay. And then, I guess, just the question was also around the ENI aspect of that in the fourth quarter. If there's any sort of catch-up, is that coming through? I think you mentioned $100 million areas of that, I guess is reflective of any sort of catch-up that comes through?

Michael Chae: The $100 million is kind of across the firm in aggregate.

Mike Cyprys: Got it. Super. Thank you.

Operator: And our next question comes from the line of Gerry O'Hara with Jefferies. Please proceed.

Gerry O'Hara: Great. Thanks for taking my question. I think I heard on the call or prepared remarks that roughly 67 percent or I guess, two thirds of the BAAM segment was now above high water. I was just curious if we could get an update as to where the remaining third was with respect to those hurdles?

Michael Chae: Sure, Gerry. So 67 percent at the end of September and – versus 10 at the end of March, which just shows you how quickly these things can move around with a bit of return. One way to think about it is subsequent to the end of third quarter, about a 2 percent further appreciation in the BAAM composite would take that 67 percent to about 90 percent.

Gerry O'Hara: Okay, helpful. And then just a follow-up, I think earlier this morning, a question came up around capacity and expanding into new sectors or asset classes that perhaps Blackstone hadn't been before. I was hoping you might be able to maybe be a little bit more specific or give some sense of what those areas or new product development might entail? Thank you.

Tony James: Well, I don't think we want to be terribly specific until we've done it for a lot of obvious reasons. But you'll be able to look at the big alternative sectors and know where we're not, and you can assume that we're thinking about all of those. In addition, while our most developed business real estate is heavily present in all regions of the world, plenty of our other businesses are really heavily concentrated still in Western markets. So there's geographic expansion.

Then, I think there is – we're working on some interesting applications of technology to drive new products, and I think those would be some interesting products there which will probably be lower fee products per dollar of AUM but quite profitable because of the cost structures and could be very, very large in terms of AUM. And then finally, I talked generically about longer duration products that are where you keep the assets and so the AUM compounds and you also get the appreciation of the net asset value as the assets grow in value. So we feel we have plenty of choices without getting too specific about precisely what products when.

Gerry O'Hara: Understood. Thank you.

Operator: And our next question comes from the line of Mike Carrier with Bank of America. Please proceed.

Mike Carrier: All right, thanks guys. Just on the private equity side, the returns in the quarter was pretty strong despite the public side not apparent as well. So I just wanted to get some perspective on the private side in terms of the portfolio trends and probably most specifically, in BCP VI, just given the strength that we saw end of the quarter there?

Michael Chae: Sure. On the private side, Mike, it was pretty widespread or spread around, so not one single theme. So our energy investments did very well as we alluded to. We have certain assets that are in queue for – to be sold, have contracts to be sold; and there was some pickup from that as we moved towards closing. And then really, it varied by region. We had assets in Asia that appreciated nicely, assets in the US and assets in Europe. So kind of multiple themes around the world as a general matter, energy, and also some assets that are on their way to being sold.

Mike Carrier: Okay. And, Mike, just on the expenses, so they definitely came in better this quarter. I know you guys usually look at it like on a year-to-date basis, but it did drive a decent amount of improvement in the FRE margin. I understand going in next year you have the fees coming on, but just how should we think about expenses as those fees are coming on and where that will take the FRE margin?

Michael Chae: Sure. Look, we had both kind of on an actual and an underlying basis adjusting for the spin, good FRE margin pickup as you saw. Given the trajectory we are on in terms of the fee revenue top-line, that will be good for margins next year and if you break it down, one thing that's sort of embedded in that is our non-comp expense declined in terms of year-over-year comparisons, and that was in part, not wholly, but in part because of the spin-off of the advisory business.

Tony James: Yeah. I just want to comment. We don't talk much about this because we tend to look at the opportunities of the market and the growth and so on, but we try to run here a very tight ship expense-wise, and we try to be very disciplined in holding our comp ratios and finding new ways through technology and consolidation and changing our business model to drive savings. And we're very, very focused on that. It's one of the parts of Blackstone I think we're particularly good at and we never talk about.

Mike Carrier: Okay. Thanks a lot.

Operator: And our next question comes from the line of Devin Ryan with JMP. Please proceed.

Devin Ryan: Thanks. Good afternoon. Maybe first one here just on the outlook for the CLO business broadly and then with risk retention rules coming later in the year. There's been some press around firms looking at some different structures just to optimize returns there. So I'm not sure if there's anything you can share around any potential changes that you might be thinking about making on this front and then if there is, how we should think about implications on either the economics or whether those might put you in a better position to capitalize on some opportunities in the space?

Michael Chae: Sure. I'll start.

Tony James: Michael is going to start and then I'll chime in.

Michael Chae: So, Devin, now, first of all, stepping back, as I mentioned in my remarks, our CLO business is really, really strong. We're basically a global leader. We are the biggest manager, have the most issuances in the last four years or five years. And the performance has been really good. So it's a very good business for us, an important one; and we do it in a high quality way.

In terms of the risk retention rules – and we know there has been some press on this – you won't be surprised to hear that since the rules were promulgated which obviously won't go into effect for another year or so, we assessed it very carefully with all the right advisers and worked through what the right structural design was. And we are very comfortable, and we intend to utilize vehicles that are designed to fully comply with both the letter and the spirit of the rules. Period.

I think in terms of what it means for the business, our CLO businesses are attractive and perform well. And so as an economic and investment matter for the firm, we obviously, first of all, have ample balance sheet resources going back to the discussion about our uses of attractive use of capital – ample balance sheet resources to make the investment required to capitalize the vehicles in the future. And moreover, we regard those required investments as quite attractive actually from a firm point of view. And then, I think in terms of our competitive position, we think that, if anything, it will only potentially further our competitive advantage because for much of the CLO competition out there with more narrow access to resources, less scale, this will be a more challenging proposition for them.

Tony James: I think that's a very complete answer. The only thing I would add is from your standpoint, the added capital that we might put up to drive this business will be small in the great scheme of things.

Devin Ryan: Okay, very helpful answers. Thank you. Just a follow-up here, maybe bigger picture, and I understand this might be a little bit of a tough one to answer. But just given the comments that you made around LP yield demand, when you think about the pace of AUM growth from here and the various buckets of where that is going to come from and ultimately what AUM could look like a few years from now, so when you look into the future, do you see the mix shifting to lower-yielding products, I guess, relative to where it is today? And if that is the case, just because maybe there's more demand there, how does that impact the economics on every dollar of AUM?

Steve Schwarzman: I'll take a shot at that, because there is no right answer. It's like speculating on the future. I see -- this is Steve -- that the alternative class is going to continue growing; and the reason is there is safety, there is high return, and there is fundamentally no place else to go.

And so that's a wonderful position. And we'll be like an army that's moving forward on all fronts. So there will be a variety of different products that will be expanding into two major channels. One is the institutional channel and the other is the retail channel.

What's going on in the institutional channel is that limited partners are going to be putting out more and more money, but they're going to be doing it to fewer and fewer general partners. This is a huge trend. I mean one very large institution just said they wanted to cut from 100 GPs down to 30, and we are in a unique position, and so they basically asked us how much money more or less could they just give us. And that's going to be repeated in a variety of different areas.

It's not a breakthrough. It's happening already. And that trend, I think, will accelerate. And there'll be a variety of products that can be sold to meet different needs in the institutional channel; but in the retail channel, there is a whole range from very high return to much more, for us, a low return but for retail customers it's great return. And so that will be lower margin, but the potential for growth is very, very large.

So this is a situation where basically everything is working and everything is going forward. And so we don't think as much as you might expect about exactly what the margin is of each product. We think about what's good for individual customers; and if we can deliver something to them that makes them really happy, then each of those products or verticals will have very substantial growth; and it'll all come together in some way that's a very happy outcome. I'm not really particularly guilty of sloppy thinking, but I've learned that it is difficult to know exactly what the future is going to be except whether it's going to be really good or whether it's going to be not so good or whether it's going to be bad. My view is that we're in a really great series of fundamentals with more and more products into two major markets with the best brand name in the world. We believe in the alternative space. And so we are in the really good zone.

Tony James: Let me just – just for your model, let me just make a couple of points. Some of these products that have lower revenue per AUM are not necessarily by any means lower margin because they have inherently lower cost structures. I would say maybe our highest margin business could be BAAM with the lowest revenue per AUM. And private equity which could arguably have the highest revenue per AUM is not a particularly high margin business today. So it's a mistake to equate revenues to margins, number one.

Number two, a lot of the additions that Steve is talking about are: we already have the foundation and the infrastructure so we can add a lot of AUM, all incremental revenues and very low incremental cost. So I think this focus on is it going to be lower margin, by which most people mean lower revenue per AUM, is misplaced actually. We are in a business that the structure is wonderful. Not only do we have locked-up capital, but with fixed costs and the capabilities we have, incremental revenues are extremely profitable.

Steve Schwarzman: And in fact, we operate with great operating leverage. That's another way I guess they talk about it in business school.

Michael Chae: I'd also just say in terms of the numbers, when we do our long-term models which we constantly update, the weighted average management fee just has actually been fairly stable in the last handful of years. It's quite stable for the long-term actually.

Devin Ryan: Great. Okay. Well, I really appreciate all the perspective and thanks for taking my questions, guys.

Michael Chae: Thanks, Devin.

Operator: And our final question comes from the line of Chris Shutler with William Blair. Please proceed.

Chris Shutler: Hey, guys, good afternoon. Just one quick one. On core-plus real estate, I know you hit the three-year point here soon where some of those fees are going be able to crystallize. I know it's going to start small, but can you just give us some sense of how that could benefit DE in '17 and '18?

Weston Tucker: Chris, we'll see management fees immediately. The performance fees are generated usually three years after the LP comes in, so we should start seeing meaningful performance fees in 2018.

Tony James: And as you know, those performance fees under that structure will be taken on an unrealized basis, not just a realized basis.

Chris Shutler: Yes. Okay.

Tony James: Just to make it clear, we'll actually get the cash but without having to sell the assets based on the marks.

Weston Tucker: So crystallized similar to our hedge fund solutions business, it'll just be in a three-year cycle rather than a one-year cycle.

Steve Schwarzman: Were you asking for like magnitude of revenue or profit or something out a few years? Was that your question?

Chris Shutler: Yeah, kind of magnitude of how it could actually impact the distributable earnings.

Weston Tucker: Yeah. It'll be dependent on the growth of the platform. Today, it's about $13 billion after three years. As you know, it will compound with the NAV, so if we achieve our targeted level of returns, that will continue to grow and we will add assets. But it's tough to know the exact AUM.

Michael Chae: Well, we obviously model this. The revenue-generating potential of this program is very large. In terms of crossing the $100 million of annual revenue mark, that is kind of –

there is visibility on that. And so we are very excited notwithstanding there are some variables in the rate of growth going forward.

Chris Shutler: Yeah, understood.

Joan Solotar: When you think about assets generally, just reading through a lot of your reports on peer companies, I would say one thing that is quite different is, and you can look all the way back to when we went public, we are not tied to this step function fundraising where we are raising a lot of assets and then we are investing, selling them down where AUM and fee earning AUM drops and then we have to wait a period to raise again. We really have never had that. And it's a combination of really scale businesses in these different areas that are on different fundraising cycles and also the build-up of perpetual assets where you don't actually sell those down and give them back. And that will only continue to increase with the product you mentioned as well as several others and I think that will continue to distinguish the steadiness of our fee earning AUM and earnings generally.

Chris Shutler: Makes sense. Thank you.

Operator: I would now like to turn the conference back to Mr. Weston Tucker for closing remarks.

Weston Tucker: Great. Thanks, everyone, for your time today and please reach out with any questions.

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